Why Development Finance Institution Co-Financing Tools Fail to Reach the Transactions That Need Them Most

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Date Written: February 12, 2026

Abstract

Development finance institutions have deployed an expanding toolkit of co-financing instruments designed to mobilize private capital for African infrastructure and SME development. Partial credit guarantees, first-loss facilities, blended finance vehicles, local currency lending programs, and political risk insurance are all available in principle to transactions that need them. In practice, these instruments consistently fail to reach the segment of the market where the financing gap is most severe: transactions in the one million to ten million dollar range that are too small for DFI direct engagement, too complex for local commercial banks, and too underprepared to qualify for the documentation-intensive processes that DFI co-financing instruments require. This paper examines the structural reasons why DFI co-financing tools miss the transactions that most need them, analyzing minimum size thresholds, documentation requirements, approval timelines, intermediation failures, and the misalignment between DFI operational incentives and the needs of smaller transactions. The paper argues that the fundamental constraint is not the availability of instruments but the absence of a transaction preparation and intermediation layer that can bring qualifying transactions to the point where DFI instruments become accessible. It concludes that private advisory platforms with genuine origination capability and DFI process familiarity represent the most practical mechanism for extending the effective reach of existing co-financing tools without requiring institutional reform.

Keywords: Development finance institutions, Co-financing, African infrastructure, SME finance, Blended finance, Financial intermediation, Transaction preparation, Missing middle

JEL Classification: G21, G23, G28, O16, O55, F21

1. Introduction

Development finance institutions occupy a central position in the ecosystem for African infrastructure and SME financing. The International Finance Corporation, the African Development Bank, the European Investment Bank, the U.S. International Development Finance Corporation, and a range of bilateral DFIs from European and Asian governments collectively deploy tens of billions of dollars annually in concessional and near-commercial financing for private sector development in Africa. Their co-financing instruments, including partial credit guarantees, first-loss tranches, political risk insurance, and local currency lending facilities, are specifically designed to address the risk and return barriers that prevent private capital from engaging with African markets.

The puzzle is why, given this institutional capacity and the range of instruments available, so much of the African infrastructure and SME financing gap remains unaddressed. The answer that most institutional assessments offer is that more DFI capital is needed, that guarantee facilities are insufficient, or that private investors are still too risk-averse. This paper argues that these explanations are incomplete. The more precise answer is that DFI co-financing tools are systematically misaligned with the characteristics of the transactions where the financing gap is most acute, and that this misalignment is structural rather than incidental.

The transactions that most need DFI co-financing support are those in the one million to ten million dollar range, where local commercial bank financing is unavailable or prohibitively expensive, where project sponsors lack the documentation and institutional capacity to access conventional capital markets, and where the underlying investment is commercially viable but requires structural support to meet the risk-return requirements of private investors. These are also precisely the transactions that DFI co-financing tools are least equipped to serve, because the minimum size thresholds, documentation requirements, and approval timelines of most DFI instruments make smaller transactions uneconomical or impractical to process.

This paper examines the mechanics of this misalignment in detail. Section 2 describes the DFI co-financing toolkit and its theoretical reach. Section 3 analyzes minimum size threshold constraints. Section 4 examines documentation and process barriers. Section 5 looks at approval timeline misalignment. Section 6 discusses intermediation failures within DFI programs. Section 7 analyzes incentive misalignment within DFI institutions. Section 8 examines the transaction preparation gap as the binding constraint. Section 9 discusses the role of private intermediaries in extending DFI reach. Section 10 concludes.

2. The DFI Co-Financing Toolkit

2.1 Available Instruments

The DFI co-financing toolkit for African infrastructure and SME transactions encompasses several distinct instrument categories, each designed to address a specific barrier to private capital engagement. Partial credit guarantees provide a commitment by a creditworthy guarantor to cover a defined portion of credit losses, addressing the credit rating constraint that prevents institutional investors from holding unrated or sub-investment-grade instruments. Political risk insurance covers specific government action risks including expropriation, currency transfer restrictions, and breach of contract, addressing the political risk concerns that deter private investors from African markets. First-loss facilities provide concessional capital in the most junior position of the capital structure, absorbing initial losses and improving the risk-return profile of senior tranches. Local currency lending programs provide debt in the currency of the project's revenues, eliminating the currency mismatch that creates financial distress when exchange rates move against dollar-denominated debt.

Each of these instruments has demonstrated effectiveness in specific transaction contexts. World Bank partial credit guarantees have enabled African sovereign and quasi-sovereign issuers to access international capital markets at investment-grade rates. DFC and MIGA political risk insurance has supported private investment in markets that private investors would otherwise avoid. IFC first-loss facilities have improved the economics of blended finance structures for a range of private investors. These successes confirm that the instruments work when applied to appropriate transactions. The question this paper addresses is why they are not applied to the full

range of transactions that could benefit from them.

2.2 Theoretical Reach Versus Actual Deployment

The theoretical reach of DFI co-financing instruments extends across the full range of private sector transactions in African markets, from large infrastructure projects to small and medium enterprise financing. DFI mandate documents and program descriptions typically do not specify minimum transaction sizes and describe the target market in broad terms that encompass the full size distribution of African private sector activity. In practice, the distribution of actual DFI co-financing deployments is heavily concentrated in larger transactions, with the average deal size across most DFI guarantee and co-financing programs substantially above the lower end of the target market.

The gap between theoretical reach and actual deployment reflects the interaction of multiple institutional factors that each individually push toward larger transactions. Minimum size thresholds imposed by cost recovery requirements, documentation standards developed for large institutional transactions, approval processes scaled for complex multi-party deals, and staff incentive structures that reward larger transactions all combine to create a systematic bias toward the upper end of the eligible transaction range. This bias is not the result of deliberate policy choice but of operational constraints that accumulate over time and are difficult to address without fundamental changes to DFI operating models.

3. Minimum Size Threshold Constraints

The most direct barrier to DFI co-financing tool access for smaller transactions is the minimum size threshold that most programs impose, either explicitly through program guidelines or implicitly through the cost structure of instrument deployment. The IFC's direct investment minimum has historically been around one million dollars for debt and five million dollars for equity, but the practical average transaction size is substantially higher because the institutional resources required to process a transaction are largely fixed regardless of deal size.

The fixed cost problem is the fundamental driver of minimum size thresholds. A DFI guarantee requires legal documentation, credit analysis, environmental and social assessment, board or management approval, and ongoing monitoring. The cost of these activities is largely independent of the size of the guarantee. For a one hundred million dollar guarantee, these costs represent a small fraction of the guarantee value. For a one million dollar guarantee, they may represent costs comparable to the entire guarantee amount, making the economics of the program unsustainable without cross-subsidy from larger transactions.

DFIs have responded to this problem in several ways, including standardized guarantee products with simplified documentation, portfolio guarantee programs that apply a single approval to a pool of smaller transactions, and delegated authority structures that

allow regional staff to approve smaller transactions without full board review. These innovations have improved DFI reach into smaller transactions but have not eliminated the fundamental economics of fixed-cost intermediation. A standardized guarantee product still requires transaction-specific assessment of the underlying credit risk. A portfolio program still requires qualifying transactions to be identified, screened, and documented to minimum standards. The minimum economically viable transaction size under most DFI co-financing programs remains well above the one million to five million dollar range where the financing gap is most acute.

4. Documentation and Process Barriers

4.1 Documentation Standards

DFI co-financing instruments were developed primarily for larger transactions with sophisticated sponsors, professional advisors, and the institutional capacity to prepare complex documentation packages. The documentation standards that DFI programs require reflect this origin. A World Bank partial credit guarantee application requires audited financial statements prepared to international standards, an independent technical assessment, an environmental and social impact assessment aligned with IFC Performance Standards or equivalent, legal opinions on the enforceability of key contracts in the jurisdiction of the project and the jurisdiction governing the debt instrument, and a detailed financial model demonstrating base case viability and downside resilience.

For project sponsors in the one million to ten million dollar range, preparing this documentation package is often beyond their institutional capacity without substantial external advisory support. The cost of engaging qualified financial advisors, environmental consultants, and legal counsel to prepare DFI-standard documentation can range from two hundred thousand to one million dollars, representing ten to one hundred percent of the transaction value for smaller deals. This documentation cost burden effectively prices smaller transactions out of the DFI co-financing market before the economics of the instrument itself are even assessed.

The irony of this situation is that the transactions most in need of DFI co-financing support, those in smaller size ranges where private capital is least available, are also the transactions least able to afford the preparation costs required to access DFI instruments. Transactions large enough to absorb the preparation costs comfortably are also large enough to attract private capital without DFI support in many cases. The documentation barrier therefore concentrates DFI co-financing resources in the segment of the market where they are least critically needed.

4.2 Process Complexity

Beyond documentation standards, the process complexity of DFI co-financing approval creates barriers for smaller transactions that are independent of the documentation requirements themselves. Most DFI guarantee and insurance programs require coordination among multiple institutional actors: the DFI's investment team, its

environmental and social team, its legal department, its risk management function, and in many cases a regional board or management committee with approval authority. Coordinating these actors for a large transaction is justified by the complexity and financial significance of the deal. For a small transaction, the same coordination burden represents a disproportionate consumption of institutional resources.

DFIs have attempted to address process complexity through simplified approval pathways for smaller transactions, including delegated authority structures and streamlined due diligence frameworks. The effectiveness of these simplifications varies across institutions and programs. In practice, the culture of thoroughness and risk management that pervades DFI institutional practice tends to reassert itself even within simplified frameworks, with staff adding documentation requirements and review steps that were not part of the simplified design. The result is that simplified processes often revert to standard complexity in application, nullifying the intended efficiency gains for smaller transactions.

5. Approval Timeline Misalignment

DFI co-financing approval timelines are misaligned with the commercial timeline requirements of the transactions they are intended to support. A World Bank guarantee application can take twelve to eighteen months from initial concept review to Board approval. MIGA insurance applications typically require six to twelve months. DFC

guarantee and insurance programs have similarly lengthy approval processes that reflect the institutional thoroughness required for instruments backed by U.S. government support.

African infrastructure transactions, particularly in the smaller size range, often have commercial dynamics that do not accommodate approval timelines of this length. A project sponsor who has negotiated a land lease, secured an offtake commitment, and identified an equity co-investor may face the loss of one or more of these commercial positions if financing close is delayed by more than three to six months. The prospect of a twelve to eighteen month DFI approval process creates a rational incentive for sponsors and investors to seek financing structures that do not require DFI instruments, even if those instruments would improve the economics of the transaction.

The timeline problem is compounded by the sequential nature of DFI approval processes. Environmental and social assessment cannot begin until the project scope is defined, which may depend on finalizing the technical design, which may depend on confirming the financing structure. Legal due diligence on contract enforceability cannot proceed until the contracts are drafted, which may require the financing structure to be substantially agreed. Each step in the process depends on the completion of prior steps, and delays at any point cascade through the timeline in ways that are difficult to predict or manage at the outset of the transaction.

6. Intermediation Failures Within DFI Programs

6.1 The On-Lending Problem

DFIs have attempted to extend their reach into smaller transactions through intermediated lending programs, channeling capital through local financial institutions with instructions to on-lend to SMEs and smaller infrastructure projects. These programs address the size threshold problem at the DFI level by aggregating many smaller loans behind a single DFI facility, but they transfer rather than resolve the structural constraints.

Local financial institutions that receive DFI on-lending facilities face the same fixed cost economics as DFIs themselves when they attempt to deploy capital in very small transaction sizes. A local bank that receives a fifty million dollar DFI credit line for SME on-lending still needs to underwrite individual loans, manage documentation, monitor performance, and enforce covenants for each borrower. The per-loan cost of these activities is similar regardless of loan size, which means that the bank's rational response is to concentrate deployment in the largest and most creditworthy borrowers within the eligible range, leaving the smaller and less documented end of the target market unserved.

Program evaluations of DFI on-lending facilities consistently confirm this pattern. The average loan size under SME-targeted facilities is substantially above the lower end of

the target range, and the enterprises with the most acute financing constraints, those that are smallest, least formally documented, and operating in secondary markets, are least likely to benefit from the facility. The DFI achieves disbursement of its credit line while the intermediating bank achieves portfolio quality, but the segment of the market that most needed the capital remains underserved.

6.2 Guarantee Intermediation

Guarantee programs intermediated through local banks face similar structural problems. A DFI partial credit guarantee on a portfolio of local bank loans to SMEs provides protection against credit losses on the guaranteed portion, but it does not reduce the underwriting cost of making the individual loans. A bank that is unwilling to lend to a five million dollar infrastructure project because of collateral gaps and documentation inadequacy does not become willing to make the loan because a DFI guarantee covers fifty percent of potential losses. The guarantee reduces loss given default but does not reduce probability of default or the cost of assessing it. The bank's rational response is to apply the guarantee to loans it would have made anyway rather than to extend credit to borrowers it would otherwise decline.

This additionality problem, the degree to which DFI guarantee and co-financing support enables transactions that would not otherwise occur, is a persistent challenge in the evaluation of DFI programs. Instruments that support transactions already within the market's reach improve the terms of those transactions but do not address the

financing gap. Instruments that extend the market's reach to genuinely additional transactions require more than financial support: they require the transaction preparation, documentation, and monitoring capacity that makes incremental lending economically rational for local financial institutions.

7. Incentive Misalignment Within DFI Institutions

The operational incentives within DFI institutions systematically favor larger transactions over smaller ones, regardless of the stated mandate to reach underserved segments of the market. DFI investment officers are evaluated on the volume of capital deployed, the development impact generated, and the financial performance of their portfolio. Each of these metrics is easier to optimize with a small number of large transactions than with a large number of small ones.

A single fifty million dollar transaction generates more deployment volume, is easier to monitor, and produces a more visible development impact story than fifty one million dollar transactions with equivalent aggregate value. The time required to originate, structure, and close a large transaction is not proportionally greater than for a small one, meaning that the productivity of an investment officer measured in dollars deployed per unit of time is higher for large transactions. Career advancement within DFI institutions is associated with managing large, high-profile transactions rather than building high-volume small-transaction portfolios.

DFI leadership has recognized this incentive problem and has attempted to address it through specific small business or inclusive finance mandates, dedicated teams for smaller transactions, and metrics that weight the number of transactions rather than only the volume. These interventions have had partial success in some institutions and programs. The underlying incentive structure reasserts itself, however, because it reflects genuine differences in the economics of large versus small transaction processing that cannot be fully resolved through mandate adjustments without fundamental changes to how DFI operations are funded and staffed.

8. The Transaction Preparation Gap as the Binding Constraint

The analysis in the preceding sections points toward a common underlying constraint: most transactions that could benefit from DFI co-financing instruments cannot access those instruments because they are not prepared to the standard that instrument application processes require. Documentation gaps, governance inadequacies, incomplete technical studies, and financial projections that do not meet institutional standards all prevent otherwise viable transactions from reaching the DFI instrument application stage.

The transaction preparation gap is a prior constraint on DFI co-financing effectiveness because it determines which transactions enter the DFI pipeline in the first place. A guarantee program that is theoretically available to transactions of five million dollars

and above is effectively available only to transactions that can afford to prepare themselves to five million dollar guarantee application standards. In practice, this means transactions that either have sponsors with substantial internal capacity, sponsors who can afford to hire specialized advisors, or sponsors who have accessed grant-funded project preparation support from donor programs.

Grant-funded project preparation programs exist within several DFI institutions and bilateral donor programs, but their coverage is limited relative to the preparation gap and their access requirements often replicate in miniature the documentation standards that are the barrier to entry at the financing stage. A project preparation grant facility that requires a preliminary feasibility study and a governance assessment as conditions of eligibility has moved the documentation barrier earlier in the process without eliminating it. Transactions that cannot prepare themselves to grant eligibility standards also cannot access the preparation support that would help them reach financing eligibility standards.

9. The Role of Private Intermediaries

The structural barriers examined in this paper share a common characteristic: they are most binding for transactions that lack the internal capacity or external relationships to navigate institutional processes, prepare compliant documentation, and maintain engagement with DFI programs over multi-year approval timelines. These are precisely

the transactions that a capable private intermediary can assist most effectively.

A private advisory intermediary operating in the African infrastructure and SME finance segment can address the transaction preparation gap by providing origination-stage advisory support that brings transactions to a preparation standard compatible with DFI instrument eligibility. This function is distinct from conventional financial advisory because it must be provided at an early stage of transaction development when the ultimate financing structure is not yet determined, at a cost level that is proportionate to transaction size, and in a way that creates genuine additionality by reaching transactions that would not otherwise access DFI instruments.

The intermediary can also address the information and access barriers that prevent smaller transactions from engaging with DFI programs effectively. DFI instruments are complex, their application processes are opaque from the outside, and the relationships required to navigate those processes efficiently take years to build. An intermediary with established DFI relationships can reduce the effective timeline and documentation burden for transactions it supports, not by circumventing DFI processes but by helping sponsors understand requirements, prepare compliant materials, and engage with DFI staff at the appropriate level from the earliest stage of the transaction.

The fee model of such an intermediary must be compatible with the economics of smaller transactions. A success fee structure, in which the intermediary is compensated only if the transaction reaches financial close with DFI instrument support, aligns the intermediary's incentives with the sponsor's and removes the upfront advisory cost burden that currently prices smaller transactions out of the professional advisory market. This structure requires the intermediary to have sufficient capital and pipeline to absorb the carry cost of transactions that do not close, which is a meaningful constraint on the scale of intermediary operations but not an insurmountable one for a platform with a diversified pipeline across multiple markets and sectors.

For U.S. investors specifically, the private intermediary function adds a distribution layer that DFI programs do not currently provide. A transaction that has been prepared to DFI eligibility standards and has obtained DFI co-financing support is still not accessible to U.S. private capital unless someone with U.S. investor relationships presents it in the format and with the framing that U.S. investors require. The intermediary who combines African market origination capability, DFI process knowledge, and U.S. investor relationships provides the full value chain from transaction identification to capital close, addressing the structural barriers at every stage rather than at only one of them.

10. Conclusion

The failure of DFI co-financing tools to reach the transactions that most need them is not primarily a failure of instrument design or of institutional commitment. It is a structural consequence of the misalignment between the operational economics of DFI institutions and the characteristics of the transactions in the most acute segment of the financing gap. Minimum size thresholds, documentation requirements, approval timelines, and incentive structures all push toward larger transactions, leaving the one million to ten million dollar range systematically underserved despite the formal availability of instruments that are theoretically applicable to it.

Addressing this misalignment through DFI institutional reform is possible in principle but has proven difficult in practice. The operational constraints that create the misalignment reflect genuine cost structures and risk management requirements that cannot be eliminated without either accepting lower institutional standards or subsidizing smaller transaction processing at a cost that would reduce the overall leverage of concessional resources. Neither option is attractive from an institutional efficiency perspective.

The more practical path to extending DFI co-financing reach to smaller transactions runs through the private sector rather than through institutional reform. Private advisory intermediaries who specialize in transaction preparation and DFI navigation can bring qualifying transactions to the point where DFI instruments become

accessible, without requiring DFI institutions to change their operating models. The intermediary absorbs the transaction preparation cost in exchange for a success fee, the DFI deploys its instruments to transactions that arrive fully prepared, and the private investor accesses a pipeline of DFI-enhanced opportunities that meet their investment mandate requirements.

This division of function is not novel in theory. It reflects the standard role of financial intermediaries in developed capital markets, where investment banks, advisors, and placement agents perform precisely this function for transactions of all sizes. What is novel in the African DFI context is the absence of intermediaries with the specific combination of capabilities required: African market origination, DFI process knowledge, and U.S. capital market distribution. Building this intermediary capacity is the missing piece that would allow existing DFI instruments to reach the transactions they were designed to serve but currently cannot.

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